

AN EVALUATION OF THE SEC'S PERFORMANCE – A PRODUCT OF LEADERSHIP

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During the past fifty years, the SEC's accounting and financial reporting performance and effectiveness depended to a large extent on the individuals who served as Chief Accountant and Director of Corporation Finance. The years under Andrew Barr were characterized by the establishment of rules and regulations in accounting and auditing matters.

The five years that followed Sandy Burton's appointment were marked by change. New rules were developed, including disclosure of replacement costs, and expansion of income tax disclosure.

The current period, under Clarence Sampson, has been a period of integration and standardization of rules. A number of deregulatory actions in the accounting area have evinced the tendency of the SEC to work with the FASB and the accounting profession.

1. Introduction

An equitable evaluation of the SEC's accounting and financial reporting performance and effectiveness during the past fifty years is largely dependent on an understanding of the regulatory environment which has prevailed and the leadership attributes of several individuals who have served as Chief Accountant and Director of Corporation Finance. Accordingly, as a preparer of financial statements for a U.S. public corporation, I have elected to develop my observations by reflecting on the activities of the Office of the Chief Accountant during three different periods. These are the first thirty-five years of the SEC, the following five years and the last eight years. I shall conclude by providing some thoughts on the current environment and opportunities for the SEC's continued effectiveness over the next decade.

2. History of the Office of the Chief Accountant and Office of Corporate Finance (1936–71) – the era of Andrew Barr and others

With the enactment of the Securities Exchange Act of 1934, Congress established the SEC and empowered it to mandate suitable accounting reports

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and principles [1]. Administration of the 1933 Act, which had been assigned initially to the Federal Trade Commission, was also made the responsibility of the SEC [2]. So, in response to the legislation, the SEC began operations and the Office of the Chief Accountant was responsible for establishing rules and regulations in matters of accounting and auditing [3]. Thereafter followed the development and adoption of the Commission's accounting and disclosure rules. Among those are Regulation S-X which covers the form and content of financial statements [4] and a number of accounting series releases (ASR), including ASR 4 which outlined, as early as 1938, the administrative policy for financial statements [5]. Right or wrong, the initial rules of the SEC were developed to fill a void in the professional literature and to minimize alleged reporting abuses. Specifically, during this period, the Accounting Principles Board (APB) issued less than approximately seventeen standards which addressed the form and content of financial statements, thus yielding by default to the SEC and Regulation S-X for authoritative guidance on these matters.

In this initial thirty-five year period, Andrew Barr served as Chief Accountant and the profession viewed the accounting and disclosure rules developed by the SEC as generally reasonable and well thought out. It was also a period in which the SEC purposely promulgated more accounting rules than it might have otherwise.

During this same thirty-five year period, the Division of Corporation Finance got underway and began the process of enforcing the accounting rules. To many, the level of enforcement was somewhat burdensome; however, the SEC is more reasonable and less bureaucratic in comparison to other government agencies.

3. The next five years (1972–77) – the Sandy Burton era

When Sandy Burton assumed the Chief Accountant's post in 1972, the APB's standards-setting process was under severe challenge; historical cost and marginal disclosure practices were being attacked. So were almost all of the accounting concepts on which financial reporting was based. Consequently, Sandy Burton sensed that a change was necessary and warranted, and that the standards-setting process was not proceeding at an acceptable pace.

So, change followed quickly and the SEC rules multiplied significantly. For example, it was during this period that Accounting Series Release (ASR) No. 190, requiring disclosure of replacement costs, was issued [6]. Line of business reporting was also mandated [7] and preferability letters from registrants' public accountants became necessary for accounting changes [8]. This proliferation of rules during the Sandy Burton era reflected the tendency to change for the sake of change, and the belief that more and different is by definition better.

During this same period, Stanley Sporkin directed the Commission's enforcement division. Under his leadership the SEC promoted corporate responsibility and morality. Additional disclosure rules were adopted, specifically those relating to audit committees and disagreements with accountants [9]. Enforcement actions were also initiated against companies who had made "questionable" payments [10].

Thus, this era of activity by the SEC staff, as encouraged by the Commission, was one of high impact and visibility. It was also the product of two determined personalities. By seeking change aggressively, Burton set the stage for Sporkin's new disclosure rules and enforcement activities.

While the Andrew Barr era had been one of "filling a void and putting meat on the bones," the Sandy Burton era challenged the standards-setting process, took broad initiatives, adopted far-reaching disclosure requirements, and put the SEC Chief Accountant's office clearly on the map. Both eras were effective; it was, however, the personality of the leadership which established the nature of the contribution.

To those of us who were preparers of financial statements, we struggled with the unrelenting disclosure requirements proliferated under Sandy Burton. In retrospect, it is now clear that we profited from a legitimate re-evaluation of time-honored reporting concepts and from an improved focus on the needs of investors. While the pendulum may have swung more than necessary during the Sandy Burton era, many of the accounting standards and disclosure requirements which the SEC implemented then have strengthened the financial reporting of public corporations in the United States. They have, in turn, enhanced the credibility of financial statements universally.

4. The most current period (1975–85) – the Clarence Sampson era

It is usually easier to evaluate the effectiveness of more recent times. Consequently, we relate to the Clarence Sampson era without difficulty. On balance, the last ten years have been a period of fairly stable activity with the leadership emphasizing modernization and the dedication of resources to rule integration. In addition, the SEC has reinforced the role of due process in making changes to reporting requirements. It has also encouraged and supported the standard-setting process in the private sector.

Specifically, the Commission has addressed the long overdue integration process [11]. Under this program, most of the SEC's forms and rules were subject to a very thorough house-cleaning. Unnecessary rules, such as Regulation S-X's provisions that duplicated generally accepted accounting principles, were eliminated [12], and rules were standardized for most filings with the Commission [13]. Other actions included the integration of shareholders' reports [14], adoption of the Financial Accounting Standards Board (FASB)

statements as SEC accounting rules [15], and a simplified standardized requirement for the disclosure of the ratio of earnings to fixed charges [16].

Separately, the Commission and Clarence Sampson have supported the FASB and have exercised accounting oversight responsibility in a prudent manner. Indeed, SEC action on accounting and disclosure matters has been initiated only when the FASB has not acted on a timely basis or the profession has failed to stand up to client pressure [17].

During this period, the Commission also undertook a number of deregulatory actions in the accounting area. Many of these were taken in response to FASB actions; others resulted from consultations with members of the accounting profession in an effort to develop self-regulatory practices. For example, the Commission adopted Safe Harbor Rules to protect those who provided earnings projections or other soft data in registration statements [18].

During this era, the Division of Corporation Finance has functioned fairly smoothly. Most preparers of financial statements are highly dependent on Corporation Finance when a registration is being processed. Thus, the contact is not a regular one; but it is, nevertheless, one where time is of the essence. By and large, Corporation Finance has consistently been sensitive to registrants' time constraints without sacrificing investors' interests. It has remained determined to ensure that prospective investors are provided with sufficient information on which to judge the merits of their investment. Although working with a small staff, the division has been available and responsive and, in turn, has kept the registration process moving smoothly.

By and large, during the Sampson era, the SEC has acted responsibly. Filings are generally processed efficiently and on a timely basis. The Commission's personnel are dedicated and, for the most part, reasonable.

4. Reflection on the past fifty years

The effectiveness of the SEC during the last fifty years has been characterized, so far, by relating the SEC's staff activities to specific personalities. Although our verdict has been positive, there are some areas where the SEC's activities are worthy of further reflection.

The universe of preparers of financial statements is large, complete with a diverse group of well-meaning professionals who work closely with their independent accountants and audit committees. Understandably, this universe is not perfect. Thus, there will be some differences of opinion on how to account for and report select items. Many of the differences are the product of how an individual views his or her "own turf" and what is representative for his or her situation. Therefore, several preparers of financial statements have expressed concern about the role of the SEC staff in imposing their judgment over management and independent accountant decisions in subjective areas.

This role has extended to the establishment of reserves [19] and has imposed the inclusion of irrelevant financial statements in registration statements, such as historical financial statements of development stage companies with no significant operations and insignificant assets and liabilities [20].

There have been at least two areas in which preparers have been at odds with the SEC, but there are others as well. One host of differences relates to current topical issues. Still another derives from the opportunities the SEC needs to face in order to remain an effective and responsible organization in the future.

Differences rooted in current reporting and disclosure concerns include items familiar to all of us. For example, the requirement that additional quarterly Form 10Q disclosures include operating results by industry segment and geographical distribution of assets has been controversial. Many believe that the SEC proposed these disclosure requirements in response to some implied need by certain members of the financial analysts' community. It could be argued, however, that broad and wholesale disclosure programs have not been thoroughly thought out and have sometimes been ill-conceived. Furthermore, the elevation of the authority of the American Institute of Certified Public Accountants (AICPA) issue papers to that of financial accounting standards is controversial [21]. Although it is understood that in many cases the AICPA issue papers are the only published documents dealing with a particular problem, many have observed that these papers should not be regarded as providing the same authority of generally accepted accounting principles. The fundamental purposes of AICPA issue papers is to call attention to accounting and reporting issues that need to be clarified or addressed by the FASB. While they may contain recommendations, the issue papers have not been subjected to traditional due process procedures and may not reflect either consensus or the best solution. In addition, preparers of financial statements and public accountants are sometimes unaware of these papers.

Along these same lines, preparers of financial statements are concerned about the SEC's increasing tendency to expand or change disclosure rules through judicial interpretations which lead to further ambiguities and inconsistencies [22]. For example, rules governing insider trading are being extended through legal proceedings rather than administrative ones [23]. As a result, administrative rule-making procedures are pre-empted and interested parties do not have the opportunity to participate in the rule-making process.

There is also a perception that the SEC prefers the use of a "shotgun" solution to problems. For example, the SEC requires all registrants to disclose information which may be meaningless for the vast majority. Working directly with registrants who share specific problems or requiring disclosure in more restrictive circumstances, would be more effective. On balance, however, preparers of financial statements feel very good about the SEC's recent performance and its responsiveness.

5. Conclusion and recommendations

Overall, I believe the investor and the investment community are now better informed because of capable, effective, and responsive leaders in the Office of the Chief Accountant and Director of Corporation Finance. In closing, however, I shall point out several emerging opportunities which warrant active SEC leadership throughout the 1980s.

The recently announced Electronic Data Gathering, Analysis, and Retrieval System (EDGAR), if successful, offers the potential for increased efficiency through electronic data-gathering, retrieval and mechanized analysis of financial data and filings. This project needs encouragement.

Another controversial development relates to the so-called "integrated" disclosure system, which has reduced the time and effort that preparers must spend on filings [24]. The system has resulted in a document which many preparers of financial statements believe is entirely too detailed for a significant portion of the shareholder population. Therefore, several experiments have been encouraged in order to determine whether a "summary report" could be a responsive substitute to the Annual Report [25].

The experiments have proceeded very satisfactorily. Regrettably, the experiments cannot be extended without relaxation of the proxy rules. To date, the SEC staff has listened attentively, but has not provided any support for proxy rule relaxation. Personally, I feel the summary reporting opportunity offers too many benefits to warrant dismissal. The SEC staff need to embrace the experiment and position themselves as responsive leaders in encouraging this effort in the 1980s.

As a preparer of financial statements, I believe the United States is fortunate to have such a fine, committed, responsive group of professionals at the SEC. Overall, the SEC staff has been extremely effective in carrying out their charter responsibilities as provided in the Exchange Act of 1934. I am confident that the past can set the precedent for the future so long as we work together on issues of mutual interest.

Notes

[1] Securities Exchange Act of 1934, § 17(a), 15 U.S.C. § 78q (1934).

[2] Securities Exchange Act of 1934, § 210, 15 U.S.C. § 78ii (1934) omitted.

[3] See R. Chatov, *Corporate Financial Reporting 102-03* (1975). The Office of Chief Accountant was not included in the SEC's initial organization. Carman G. Blough joined the SEC as a financial analyst on December 1, 1934. In 1935, Blough became the first SEC Chief Accountant. *Id.*

[4] Accounting Regulation S-X, 17 C.F.R. § 210 (1984).

[5] SEC Accounting Series Rel. No. 4, Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards (April 25, 1938) [hereinafter cited as ASR 4].

[6] SEC Accounting Series Rel. No. 190, Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data (March 23, 1976) [hereinafter cited as ASR 190].

[7] *See, e.g.*, SEC Accounting Series Rel. No. 279, Amendments to Annual Report Forms, Rules, Regulations, and Guides, Integration of Securities Acts Disclosure Systems (Sept. 2, 1980) [hereinafter cited as ASR 279].

[8] SEC Accounting Series Rel. No. 177, Notice of Adoption of Amendments to Form 10-Q and Regulation S-X Regarding Interim Financial Reporting (Sept. 10, 1975) [hereinafter cited as ASR 177].

[9] *See, e.g.*, SEC Accounting Series Rel. No. 165, Notice of Amendments to Require Increased Disclosure of Relationships Between Registrants and Their Independent Public Accountants (Dec. 20, 1974).

[10] *See, e.g.*, SEC v. Lockheed Aircraft Corp., Fed. Sec. L. Rep. (CCH) ¶ 95,509 (D.D.C. 1976).

[11] *See, e.g.*, SEC Accounting Series Rel. No. 306, Adoption of Integrated Disclosure System (March 3, 1982).

[12] SEC Accounting Series Rel. No. 280, General Revision of Regulation S-X (Sept. 2, 1980) [hereinafter cited as ASR 280]; SEC Accounting Series Rel. No. 286, New Interim Financial Information Provisions and Revision of Form 10-Q for Quarterly Reporting (Feb. 9, 1981).

[13] SEC Accounting Series Rel. No. 281, Uniform Instructions as to Financial Statements – Regulation S-X (Sept. 2, 1980).

[14] *See* ASR 279, *supra* note 7.

[15] *See* ASR 4, *supra* note 5; ASR 280, *supra* note 12.

[16] Accounting Regulation S-K, 17 C.F.R. § 229.503 (1984).

[17] For the Commission's position on this point, *see* ASR 280, *supra* note 12. An example of this position is the imposition of a requirement to classify preferred stock which is subject to mandatory redemption, or whose redemption is outside the control of the issuer, outside of the shareholder's equity section of the balance sheet. *See also* SEC Accounting Series Rel. No. 268, Presentation in Financial Statements of "Redeemable Preferred Stocks" (July 27, 1979) (proposing that interim segment data be disclosed quarterly in Form 100 after the FASB dropped its project on interim financial statements); ASR 177, *supra* note 8.

[18] A safe harbor mechanism is designed to recognize that if certain data, such as forecast or inflation information, have a reasonable underlying basis, and are prepared with reasonable care and in good faith, the data do not constitute "an untrue statement of material fact" or a "manipulative, deceptive, or fraudulent device." This is designed to encourage management to present meaningful user information without fear that such prospective data will subject them to unreasonable liabilities under the securities laws. *See, e.g.*, ASR 190, *supra* note 6.

[19] Financial Reporting Rel. No. 20, Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property Casualty Underwriters (Nov. 27, 1984).

[20] Accounting Regulation S-K, 17 C.F.R. § 229.301 (1984).

[21] *See, e.g.*, SEC Staff Accounting Bull. No. 58.

[22] *See, e.g.*, *Dirks v. SEC*, 103 S.Ct. 3255 (1983) (Rule 10b-5 is violated when tippee assumes a fiduciary duty to shareholders not to trade on inside information when insider has breached his or her fiduciary duty by disclosing information to tippee and tippee knows or should have known of the breach).

[23] *Id.*

[24] *See* ASR 279, *supra* note 7.

[25] These efforts have been spearheaded by the Financial Executives Institute, Committee on Corporate Reporting.

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